

**Testimony of J. Richard (Dick) Harvey, Jr.**  
**Before the U.S. Senate Permanent Subcommittee on Investigations**  
**May 21, 2013**

Chairman Levin, Ranking Member McCain, and members of the Subcommittee, thank you for the opportunity to testify this morning on issues surrounding the shifting of profits by MNCs to low-tax jurisdictions, and specifically the techniques used by Apple, Inc. This is a very important topic that deserves to be highlighted and discussed.

I am the Distinguished Professor of Practice at the Villanova University School of Law and Graduate Tax Program. Immediately prior to joining the Villanova faculty I was the Senior Advisor to former IRS Commissioner Doug Shulman where my focus was international tax issues and improving corporate tax transparency (e.g., Schedule UTP). I joined the IRS upon retiring from a Big 4 accounting firm as a Managing Partner and my experience also includes prior government service in the US Treasury Department Office of Tax Policy during the negotiation and implementation of the 1986 Tax Reform Act.

With the Chairman's permission, I request that my written testimony be submitted for the record and I will summarize my major observations in oral remarks.

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**Executive Summary**

Apple, Inc. (Apple) is an iconic US multinational corporation (MNC) that has enjoyed extraordinary financial success. In addition to demonstrating excellence in designing, building, and selling consumer products, Apple has been very successful at minimizing its global income tax burden. For example:

- Pursuant to a long-standing cost sharing agreement, Apple recorded approximately \$22 billion of its 2011 pre-tax income in Ireland.<sup>1</sup> As a result, 64% of Apple's global pre-tax income is recorded in Ireland where only 4% of its employees and 1% of its customers are located.
- If Apple had not entered into the cost sharing agreement, 2011 US pre-tax income would have increased by approximately \$22 billion resulting in an additional federal tax liability of approximately \$22 billion x 35% = \$7.7 billion.
- Despite a published tax rate of 12.5%, Apple negotiated a special tax deal that resulted in only \$13 million of Irish tax expense being recorded with respect to the \$22 billion of Irish income.

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<sup>1</sup> During the period 2009-2012, the total pre-tax income recorded in one Irish entity, Apple Sales International (ASI), was approximately \$74 billion. There were no employees in ASI until 2012 when 250 employees appear to have been transferred from another Irish entity.

- 60% of Apple's 2011 sales were to customers in countries other than the US and Ireland, but only 6% of the consolidated pre-tax income was recorded in such countries.

Although shifting income out of the US and locating it in a tax haven like Ireland are key steps in Apple's international tax planning, Apple must also avoid the so-called "Subpart F" rules. These rules were originally designed to tax passive income earned by foreign subsidiaries of US MNCs and therefore discourage the shifting of income out of the US. However, the rules have been substantially "gutted" through adoption of (i) the check-the-box regulations, (ii) the CFC look-through rule, (iii) the contract manufacturing exemption, and to a lesser extent (iv) the same-country exception.

In order to restore the effectiveness of the Subpart F rules and discourage the shifting of income from the US, Congress should quickly adopt the following tax policy recommendations:

- **Substantially restrict the tax planning tools used to circumvent Subpart F** – The check-the-box regulations should be restricted for foreign entities, the CFC look-through rule should at most apply to only dividends, the contract manufacturing exemption should be either eliminated or substantially tightened, and the same-country exception should be modified.
- **Increase transparency** – It is often very difficult for the IRS to get a true picture of a MNC's global tax planning. Thus, US MNCs should be required to report the geographical location of income, tax, and other pertinent information.

Although adoption of these proposals would be very beneficial, additional tax policy changes will also be needed. The reason is that as long as the US (and the rest of the world) applies an arms-length pricing standard to transactions between controlled parties, there will be an opportunity for MNCs to shift income. As a result, a longer-term solution will ultimately be needed. My personal recommendations, in order of preference, are as follows:

- **Obtain global consensus on how to address corporate tax havens** – Unfortunately, this could be very difficult and the US may have to act unilaterally.
- **Substantially lower the corporate tax rate and replace the lost revenue with a VAT or other revenue source** - However, this is likely a political nonstarter.
- **If the arms-length standard is maintained, there needs to be adequate base erosion protections** - For example, a minimum tax should be imposed on earnings recorded in a tax haven, and US deductions for expenses related to foreign income should be restricted (e.g., interest). If a minimum tax is adopted, emphasis should be on making the minimum tax relatively simple to calculate and audit.
- **Consider replacing the arms-length standard with a formula apportionment approach if adequate base erosion protections are not enacted** – However there are major design issues that would need to be addressed.

## **Selected Apple Information**

Per a review of both (i) information supplied by Apple to the Permanent Subcommittee on Investigation (PSI) and (ii) publicly available information in its Form 10-K, a clearer picture emerges about the results of Apple's international tax planning. For example, the table below summarizes the geographic location of 2011 pre-tax income, employees, and customers:

Country	2011 Pre-Tax Income		Employees @ June 2011 <sup>2</sup>		2011 Customer Location <sup>3</sup>
	\$ Billions	%	#	\$	
United States	10.2	30%	67%	79%	39%
Ireland	22.0	64	4	3	1
Other countries	<u>2.0</u>	<u>6</u>	<u>29</u>	<u>18</u>	<u>60</u>
Consolidated	<u>34.2</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

In addition, the effective tax rate on all foreign earnings was approximately \$600 million/\$24 billion = 2.5% with substantially all of the \$600 million of tax being incurred on the \$2 billion of income earned from foreign countries other than Ireland.

The information below on the profitability of US vs. non-US operations and the allocation of certain expenses between US and non-US operations is also of potential interest:

	Pre-tax Income/Sales	% of Pre-tax Income	General & Administrative Expenses		Sales, Marketing, & Distribution Expenses	
			\$ billions	%	\$ billions	%
US	24%	30%	1.7	85%	3.3	59%
Non-US	36%	<u>70%</u>	<u>0.3</u>	<u>15%</u>	<u>2.3</u>	<u>41%</u>
Consolidated	32%	<u>100%</u>	<u>2.0</u>	<u>100%</u>	<u>5.6</u>	<u>100%</u>

In addition to the above summary information, there is substantial information summarized in the PSI report prepared for today's hearing that sheds additional light on Apple's international tax planning.

<sup>2</sup> At June 2011, Apple's total employees worldwide were approximately 59,000 while total worldwide compensation was approximately \$6.9 billion.

<sup>3</sup> Customer location based upon information provided in the 2011 consolidated financial statements, except for Ireland that was assumed to be <1% based upon the relative size of Ireland's population.

## **Major Observations Surrounding Apple**

Having reviewed the Apple information several major observations can be made,<sup>4</sup> including:

- **Apple received a substantial US tax benefit from a “cost sharing agreement”** - The \$22 billion of pre-tax income recorded in Ireland results from a cost sharing agreement whereby Apple transferred to Apple Sales International (ASI), an Irish entity, its development rights to Apple products outside of the Americas.<sup>5</sup> If Apple had not transferred these rights to ASI, 2011 US pre-tax income would have been approximately \$22 billion higher.<sup>6</sup>
- **The overall effective tax rate on Apple’s foreign earnings is only 2.5%** - Apple was able to achieve this very low rate through the following:
  - **Negotiated Irish tax** - In addition to having a disproportionate amount of pre-tax income recorded in Ireland,<sup>7</sup> the effective tax rate charged on the \$22 billion of Irish income appears to be less than 1%.<sup>8</sup> Given the stated corporate tax rate in Ireland is 12.5%, it seems very clear that Apple negotiated a special deal with the Irish tax authorities.<sup>9</sup> If this special deal is not already known by finance ministers around the world, it will be interesting to see their reaction when it becomes known after this hearing.<sup>10</sup>

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<sup>4</sup> These observations are not meant to conclude that Apple has done anything improper from a tax planning perspective. Such determination could only be made after a detailed audit of Apple’s facts.

<sup>5</sup> Technically the agreement is with both ASI and Apple Operations Europe (AOE). However, it appears that AOE is functioning as primarily a holding company.

<sup>6</sup> ASI’s pre-tax income in 2002, 2010, and 2009 was approximately \$36 billion, \$12 billion, and \$ 4 billion respectively. Thus, for the four-year period 2009 to 2012, Apple’s cost sharing agreement with ASI effectively resulted in a reduction in US pre-tax income of approximately \$74 billion. In addition, the cost sharing expenses incurred by Apple’s Irish entities for the period 2004 to 2011 were approximately \$5 billion. Thus, Apple’s Irish entities were able to spend \$5 billion to obtain pre-tax income before such expenses of at least \$74 billion + \$5 billion = \$79 billion.

<sup>7</sup> 64% of the consolidated pre-tax income was recorded in Ireland when (i) only 4% of the global workforce and 3% of global compensation expense is located in Ireland, and (ii) approximately 1% of customers are located in Ireland.

<sup>8</sup> The total tax expense recorded in Apple’s 2011 Consolidating Income Statement for Apple Sales International (ASI) and Apple Operations Europe (AOE) was only \$13 million (i.e., an effective tax rate of \$13 million/\$22billion = 0.06%). Per information supplied by Apple, ASI is not taxed as an Irish resident corporation. Thus, it appears to only be taxed on certain business activity in Ireland.

<sup>9</sup> Apple reportedly confirmed this hypothesis in discussions with the PSI staff.

<sup>10</sup> During negotiations of Ireland’s bailout by the EU in 2010, there was reportedly discussion about forcing Ireland to increase its corporate tax rate and eliminate special tax deals. Nevertheless, Ireland was able to obtain its bailout without any material tax changes. Will the EU be so generous in the future?

- **Very little income recorded in countries other than the US and Ireland** - Although 60% of its 2011 sales were to customers in countries other than the US and Ireland, only 6% of the consolidated pre-tax income was recorded in such countries. This result was accomplished by recording substantially all of the pre-tax income from customers outside of the Americas in ASI. Entities in foreign countries other than Ireland received only a small commission for the sale of goods into their respective countries.
- **Irish holding company managed and controlled outside of Ireland** - Apple's foreign holding company, Apple Operations International (AOI) is incorporated in Ireland but managed and controlled elsewhere.<sup>11</sup> As a result, dividends received by AOI from both Irish and non-Irish companies escape Irish taxation. If AOI was taxed in Ireland like other Irish corporations, it would have incurred a 25% tax on dividends received from subsidiaries located in non-EU countries.<sup>12</sup>
- **Apple avoided substantial US taxation by side-stepping Subpart F income** - Subpart F of the US tax law was designed to tax passive income of the type generated by Apple's Irish operations. However, Apple avoided substantial subpart F income<sup>13</sup> through use of (i) the check-box-regulations, (ii) CFC look-through rules, and (iii) the same country exception. In the future, Apple may also attempt to argue the contract manufacturing exemption applies. See Section 1 of the Appendix accompanying this testimony for a discussion of how these techniques are used by US MNCs to avoid Subpart income.
- **US operations are less profitable than non-US operations** - The ratio of pre-tax income to net sales is 24% in the US, but 36% for non-US operations. In addition, both general and administrative (G&A) expenses and sales, marketing, and development (SM&D) expenses as shown on Apple's 2011 consolidating income statement appear to be disproportionately allocated to the US.

If G&A expenses were allocated based on pre-tax income and SM&D expenses were allocated on the basis of sales, US pre-tax income would increase by approximately \$2.2 billion and the ratios of pre-tax income to net sales would become 30% in the US and 33% outside the US. The

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<sup>11</sup> Apple apparently has not affirmatively concluded where this entity is "managed and controlled", but it is worth noting that the US would seem to be the only other possibility. For example, Board of Directors meetings are held in the US and bank accounts are in the US.

<sup>12</sup> Since very little income was recorded in other foreign countries, this tax planning does not appear to have produced a material tax benefit to Apple. In addition, the 25% tax could have been reduced in certain cases through tax treaties.

<sup>13</sup> Apple did report some subpart F income, but the amount was relatively immaterial (i.e., approximately \$100 million in 2011) and related to interest income from 3<sup>rd</sup> parties.

resulting 3% difference in profitability (as opposed to the 12% actual difference) could be easily explained by differences in product mix around the world.

Thus, even after taking into account the cost sharing arrangement, Apple's allocations of G&A and SM&D expenses between US and non-US operations are curious and could contribute to the decreased profitability of US vs. non-US operations. The impact of these allocations on the 2011 US tax liability could be as much as  $\$2.2 \text{ billion} \times 35\% = \$0.8 \text{ billion}$ .

In summary, by entering into the cost sharing agreement with its Ireland affiliates and negotiating a special tax deal with Ireland, Apple was able to shift approximately \$22 billion of its 2011 pre-tax income out of the US into Ireland and incur an immaterial amount of Irish tax. If such income had been taxable in the US, Apple would have incurred approximately  $\$22 \text{ billion} \times 35\% = \$7.7 \text{ billion}$  of additional US federal tax.<sup>14</sup> As demonstrated by many prior studies, Apple's efforts to shift income from the US to a tax haven jurisdiction are not unique. However, given Apple's overall profitability the magnitude of income shifting is startling.

### **Key Steps to Shifting Income Overseas**

Before discussing the tax policy implications of income shifting, it may be helpful to summarize the key steps US MNCs take to shift income to tax haven jurisdictions and ultimately obtain a financial statement tax benefit. It is important to note that the goal of international tax planners is to shift income with minimum disruption to the business's operations. Thus, the transfer of intangible assets (or the use of creative financing structures) is clearly preferred since it involves only minimal disruption to a MNC's normal operations.<sup>15</sup>

- **Contribute equity to a foreign subsidiary** - An equity contribution to a foreign subsidiary is usually the first step in shifting income out of the US. For example, if a US parent contributes \$1 billion of cash to a tax haven affiliate and the tax haven affiliate invests the \$1 billion at a 10% rate of return, the US parent has effectively shifted  $\$1 \text{ billion} \times 10\% = \$100 \text{ million}$  of income out of the US annually. Although annually shifting \$100 million of income can produce a significant tax benefit, US MNCs can often shift further income as described below.
- **Transfer valuable intangible asset, but minimize the compensation paid** - A transfer may be accomplished through a variety of means (e.g., a cost sharing arrangement with or without a

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<sup>14</sup> There also could have been additional state and local taxes

<sup>15</sup> However, in order to provide some substance to the transactions for tax purposes, international tax planners will often move some assets or employees to improve the optics of the transfer. For example, Apple had approximately 2,500 employees in Ireland in 2011, but this was still only 4% of its 2011 global workforce with the end result that 60% of Apple's 2011 global pre-tax income was transferred to Ireland.

buy-in payment, an outright sale, a license, or a contribution to capital). More importantly, since the valuation of unique intangible assets is extraordinarily difficult, MNCs have a significant incentive to assign the lowest possible value. The use of a cost sharing arrangement allows a US MNC to shift an intangible asset before it is fully developed and therefore assign an even lower value. And in some cases (e.g., Apple), the transfer takes place before any material development in which case the tax haven affiliate only needs to share costs with its US parent and does not need to make a buy-in payment.

Continuing with the prior example, assume the tax haven affiliate uses the \$1 billion contributed from its US parent to acquire an intangible asset with an estimated value of somewhere between \$1 billion and \$5 billion. In such case, if the tax haven affiliate acquires the intangible asset for \$1 billion, but it ultimately turns out to be worth \$5 billion, the US MNC has effectively shifted another \$4 billion of income out of the US (i.e., in addition to the earnings on the original \$1 billion equity contribution).

It should be noted that even if the payment from the tax haven affiliate to the US parent is at true fair market value for the intangible assets transferred, as described above the US parent has effectively shifted income to the tax haven affiliate by virtue of the equity contribution.

- **Isolate substantial non-US income in the tax haven entity** - This can be accomplished by a variety of means. In Apple's case, substantially all of the non-US income was isolated in Ireland. This result was achieved by having ASI own the development rights outside of the Americas coupled with ASI entering into a contract manufacturing agreement with a 3<sup>rd</sup> party supplier located in China (i.e., Foxconn). ASI then sold the products manufactured by Foxconn to other Apple entities. ASI was treated as the principal in the transaction and Apple's other foreign entities appear to have only received relatively small commissions for aiding in the distribution and sale of Apple products to customers. The end result was that substantially all of the income was isolated in ASI.

In tax planning structures used by other MNCs, the valuable intangible may be held in a separate tax haven entity that charges a substantial royalty to operating entities. Regardless of the actual structure used, the goal is isolate as much non-US income as possible in tax haven entities.

- **Avoid Subpart F income for US tax purposes** - As described previously, Subpart F income was originally designed to tax passive income (e.g., interest, dividends, and income related to intangible assets) earned by foreign affiliates of US MNCs. However, as described in Section 1 of the Appendix to this testimony various techniques can be used to avoid subpart F income (e.g., check-the-box regulations, CFC look-through rule, manufacturing exemption, and to a lesser extent the same country exception).

- **Adopt “indefinite reinvestment” assumption for financial accounting purposes** – Even though a US MNC may successfully shift income to a tax haven entity, current US tax law still imposes a tax upon repatriation of the earnings from the foreign subsidiary to the US. Accounting rules generally require that a deferred US tax expense be recorded for the potential future US tax upon repatriation. However, this deferred tax expense is not recorded if the earnings of the foreign subsidiary are considered “indefinitely reinvested”. Most US MNCs assume 100% or a very high percentage of their earnings in tax haven affiliates are indefinitely reinvested. Apple is relatively conservative and only assumes approximately 50% of the earnings from their Irish affiliates are indefinitely reinvested.<sup>16</sup>

The above discussion focused primarily on the transfer of intangible assets, but US MNCs also use various creative financing structures to shift income to tax haven affiliates (for an example, see Section 1.2 of the Appendix to this testimony). In addition, as possibly demonstrated by Apple’s disproportionate allocation of G&A and SM&D costs to the US, routine cost allocations can also be a method used to shift income out of the US. Although the amount of income transferred overseas from the use of creative financing structures and routine cost allocations can be very material, the income transferred from intangible assets is usually even more material.

## **Key Tax Policy Questions**

Given this background, the question quickly becomes: What action, if any, should Congress take to address income shifting? Unfortunately, there is no silver bullet. Plus, the specific action may depend upon Congress’s view on the following questions:

- Are US policy makers only concerned about US MNCs competing against foreign MNCs, or are they also concerned about the ability of US domestic businesses to compete with US MNCs that can shift substantial income offshore?
- Does current US tax law really put US MNCs at a competitive disadvantage vs. foreign MNCs?
- Should the US act unilaterally, or wait for OECD or some other global action?
- If the US acts and cracks down too much on US MNCs, could US MNCs eventually shift even more operations overseas or expatriate their headquarters from the US?

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<sup>16</sup> This is one of the reasons why Apple’s effective tax rate disclosed on its 2011 financial statements is 24.2%. If Apple had assumed that 100% of its foreign earnings were indefinitely reinvested, the disclosed 2011 effective tax rate would have decreased to approximately 12.8% (i.e., \$8.283 billion of reported tax expense – \$3.917 billion increase in the deferred tax liability on unremitted foreign earnings = \$4.366 billion adjusted tax expense/\$34.205 billion of pre-tax income).

- Assuming global consensus is not forthcoming, is there a US policy response that could balance the competing policy goals?
- Should the US retain the arms-length standard and if so, what protections are needed to protect the corporate tax base from erosion?

These are all hard questions that could cause reasonable policy makers to disagree. Each is discussed in more detail below.

- **US MNCs vs. US domestic companies** - US MNCs have done an excellent job of framing the competitiveness issue in terms of US MNCs competing against foreign MNCs. However, that is only half of the competitive issue. If US MNCs are able to shift substantial income offshore, US domestic companies could be put at a competitive disadvantage. In addition, in order to compete, US domestic companies may decide they need to move some of their operations offshore with the resulting loss in jobs and US taxable income.

Given US domestic companies currently employ all of their workers in the US, putting them at a disadvantage may not be the best answer for a country that is struggling with persistently high unemployment. Nevertheless, by the same token, US tax policy should attempt to avoid putting US MNCs at a competitive disadvantage vs. foreign MNCs. This leads to the second key question.

- **Are US MNC's disadvantaged?** - Again, US MNCs prefer to focus on the element of US tax law that is competitively detrimental; the so-called lockout effect resulting from the taxation of dividends repatriated to the US. The lockout effect is a real problem for US MNCs, but one needs to also focus on what is causing the problem. Specifically, I believe the US MNC's lockout problem is primarily driven by the excessive amounts of income they have shifted outside the US. If such income had not been shifted, US MNCs would likely have a substantially smaller or non-existent lockout issue. Said differently, many US MNCs have been "hoisted on their own petard" by virtue of excessive income shifting out of the US.

Often forgotten in the discussion are the elements of US tax law that may give US MNCs a competitive advantage over foreign MNCs, including:

- **Subpart F rules are no longer effective** - Historically the US had the toughest rules surrounding passive income earned by foreign subsidiaries, but with the introduction of the check-the-box regulations, the CFC look-through, and the contract manufacturing exemption the US rules are no longer effective. As a practical matter US MNCs can easily avoid the rules and could be at a competitive advantage vs. MNCs from certain countries.

- **Ability to obtain a US deduction for expenses related to foreign subsidiaries** – This is especially the case for interest expense incurred in the US, but is also applicable to other expenses. For example, under current US tax law a US MNC can borrow in the US and fund its foreign operating entities through various creative tax structures.<sup>17</sup> The end result is the US MNC claims a US tax deduction for interest related to foreign operations, but can avoid the recognition of any foreign income.
- **Cross-crediting of Foreign Tax Credits (FTCs)** – If a foreign subsidiary incurs a relatively high tax rate (e.g., through tax losses not being allowed to be carried back to prior years), US tax law allows those high taxes to offset the US tax that would otherwise be incurred on low-taxed foreign earnings. This benefit is generally not available to foreign MNCs.

Overall I believe US MNCs are generally no worse off than foreign MNCs and in many cases may be better off. As a result, if Congress decides to impose restrictions on transferring income overseas, US MNCs should not be put at a competitive disadvantage vs. foreign MNCs.

- **Unilateral vs. global action** - If a global consensus is possible within a reasonable period of time and would be effective, it would be the best way forward. Given the OECD is working feverishly on its Base Erosion and Profit Splitting project<sup>18</sup> and is scheduled to disclose the results in June or July of this year, it is possible that a global consensus could emerge. Thus, Congress should clearly keep abreast of future OECD recommendations. But if history is any guide, it often takes OECD recommendations many years to come to fruition.

In addition, it often takes leadership from the US or other countries to jump-start global consensus on an issue. For example, the US adoption of FATCA addressing the reporting of offshore accounts has resulted in significant global coordination and action in the past 2 years. Thus, there may be a need for the US to take action on income shifting to spur the rest of the world into action.

- **Could the US crack down too hard on US MNCs?** - The short answer is yes. Since there will always be countries that will offer MNCs an attractive location to operate and/or relocate their headquarters operations,<sup>19</sup> US policymakers need to be concerned about the long-term impact of any proposals. For example, if the US were to unilaterally adopt full worldwide taxation without deferral of active income from foreign subsidiaries, there would be significant risk that

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<sup>17</sup> See Section 1.2 of the Appendix of this testimony for a description of a specific financing structure.

<sup>18</sup> For more information see <http://www.oecd.org/tax/beps.htm>.

<sup>19</sup> In addition, countries that are not tax havens could still engage in tax competition (i.e., the UK and other countries continue to decrease their corporate tax rates).

over time US MNCs would figure out a way to eventually expatriate out of the US to take advantage of substantially lower rates in tax havens.<sup>20</sup>

- **Assuming global consensus is not forthcoming, is there a US policy response that could balance the competing policy goals?** – Possibly, but it is very unlikely to get serious political consideration. One policy response that would allow US MNCs to compete effectively with foreign MNCs and not have a competitive advantage over US domestic businesses would be to lower the US corporate income tax rate to 15% or less and replace the lost revenue with another revenue source (e.g., VAT). Although they are collected differently, a VAT and the corporate income tax have some similarities. For example, when compared with a corporate income tax, a VAT does not allow a deduction for labor costs, but does allow a 100% deduction for capital expenditures.
  
- **Should the US retain the arms-length standard and if so, what protections are needed to protect the corporate tax base from erosion?** – These two questions have been at the heart of much of the recent debate surrounding international tax reform and will likely be the subject of much discussion by the OECD as it develops its recommendations for its BEPS project. My views on these two questions, in reverse order, are as follows:
  - **Arms-length standard requires strong base erosion protections** - If the arms-length standard is retained and US MNCs can continue to (i) make equity contributions to foreign subsidiaries and (ii) transfer valuable intangible assets to foreign subsidiaries, it will be crucial that steps be taken to minimize base erosion (e.g., restoring the vitality of Subpart F, imposing a minimum tax on tax haven income, and limiting the deductibility of interest).
  
  - **Abandoning the arms-length standard requires a determination of how income should be allocated** - For example, where should the income attributable to intangible assets developed in the US be taxed? If it is the US, will it cause US MNCs over time to transfer their research activities overseas? In summary, if the arms-length standard is abandoned, there will be a need to determine what factors of production should be used to allocate income to various tax jurisdictions. A multilateral approach would be strongly preferred, but if history is any guide, multilateral action is unlikely.

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<sup>20</sup> This would likely be the case even if the US decreased its corporate tax rate to somewhere in the 20-30% range. A US tax rate of 15% or less would likely be needed to minimize the incentive for US MNCs to expatriate if deferral were eliminated.

## **Immediate Tax Policy Recommendations**

Clearly there are many potential views on the key questions discussed above, and as a result there will be significant tax policy debates surrounding the appropriate taxation of MNCs. Nevertheless, given that it is generally agreed that the Subpart F rules have recently been “gutted”, I believe Congress should seriously consider the following sooner rather than later:

- **Substantially restrict the check-the-box regulations, the CFC look-through rule, and the contract manufacturing exemption** – The Subpart F rules were designed to make it very difficult for passive income related to intangible assets and creative financing structures to be shifted out of the US. As discussed further in Section 1 of the Appendix of this testimony, the relatively recent adoption of the check-the-box regulations, the CFC look-through rule, and the contract manufacturing exemption have allowed US MNCs to effectively avoid the Subpart F rules.

Said differently, US MNCs have been able to shift income from both<sup>21</sup> the US and high-tax foreign countries and locate the income in a tax haven without much fear of triggering the US Subpart F rules. The following suggestions would help restore the original vitality of the Subpart F rules:

- **Restrict check-the-box regulations for foreign corporations** – Although there could be several options to accomplish this goal, one is to require conformity in treatment between US and foreign tax law. For example, if the foreign entity is treated as a corporation for local tax law purposes, it should be treated as a corporation for US tax purposes. Another option would be to expand the list of per-se foreign corporations (i.e., foreign corporations treated as corporations for US tax law). In summary, the goal of any change to the check-the-box regulations should be to minimize the ability of MNCs to create hybrid entities whereby the entity is respected for one country and disregarded for the other.
- **CFC look-through rule should at most apply to only dividends** - When the CFC look-through rule was enacted in 2006 I was personally stunned it was made applicable to payments other than dividends (e.g., interest and royalties). The end result has been that US MNCs can locate intangible assets and financing operations in tax havens and avoid Subpart F income. Congress should consider either totally eliminating the CFC look-through rule or alternatively only allow it to be applied to dividends.
- **Contract manufacturing exemption should be eliminated or substantially tightened** – The original Subpart F rules were designed to exclude from US taxation the income earned by a foreign corporation to the extent (i) the property was manufactured in the

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<sup>21</sup> This is an important point. US MNCs prefer to discuss the use of these techniques to strip income from high-tax foreign countries, rather than the US. However, in reality they are using these techniques to aid the shifting of income from both the US and high-tax foreign countries to tax havens.

foreign country or (ii) the property was sold to customers in such country. In the good old days, “manufactured” meant that the foreign corporation had a plant in the foreign country and actually manufactured something in the plant. Not so any more.

In 2008 the IRS and Treasury issued regulations allowing supervision of contract manufacturing to qualify as manufacturing.<sup>22</sup> As a result, the manufacturing exemption to Subpart F income has been greatly expanded allowing US MNCs to avoid substantial amounts of US taxable income.<sup>23</sup>

Although there could be many potential changes to the contract manufacturing exemption, the easiest solution would be to just eliminate it. Another option might be to only allow the foreign corporation to avoid Subpart F to the extent of the labor cost of the supervisory services provided plus some reasonable profit margin.

- **Same country exception should be modified** - See discussion in Section 1.4 of the Appendix to this testimony.

It needs to be emphasized that all of these suggestions should be adopted as a package. If only one or two are adopted, US MNCs will be able to use the remaining techniques to accomplish their tax planning goals.

- **Increased transparency** – Currently it is very difficult for the IRS and tax administrators around the world to get a true picture of a US MNC’s effort to shift income to low tax jurisdictions. As discussed in more detail in Section 2 of the Appendix to this testimony, there should be increased transparency surrounding the worldwide tax position of MNCs. Information might include a schedule summarizing where income is recorded for both financial accounting purposes and tax purposes, the amount of tax paid, and other information of potential use to tax administrators.

## **Broader Tax Reform Recommendations**

Although the above proposals would be very beneficial in turning the clock back on income shifting by restoring the vitality of the Subpart F rules, additional tax policy changes will also be needed. The reason is that as long as the US (and the rest of the world) applies an arms-length pricing standard to

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<sup>22</sup> Regulation 1.954-3(a)(4)(iv).

<sup>23</sup> Said differently, the combination of the ability of US MNCs to transfer valuable intellectual property to a foreign corporation coupled with the foreign corporation’s ability to then enter into a contract manufacturing arrangement allows for the shifting of significant income out of the US.

transactions between controlled parties, there will always be opportunity for MNCs to shift income to tax havens. The arms-length standard was developed almost 100 years ago and from a pure conceptual basis it makes some sense. The problem is getting it to work in practice, especially in today's world where:

- Production and distribution functions are no longer vertically integrated in one foreign country,
- MNCs exercise substantial or complete control over their foreign subsidiaries,
- Intangible assets being transferred are extraordinarily unique and difficult to value, and
- MNCs seek to exploit the arms-length standard by spending significant time and money developing plans to shift income to tax haven jurisdictions.

As a result, tax administrators around the world are wrestling with the issue of how to address the shifting of income by MNCs to tax haven jurisdictions. As I have stated previously, even though the IRS has greatly increased its resources for auditing transfer pricing issues, "anyone who believes the IRS can effectively enforce the arms-length standard is either eternally optimistic -- or delusional".<sup>24</sup>

For these reasons, a longer-term solution is ultimately needed. But again, there are many options<sup>25</sup> and the potential for reasonable policymakers to disagree. My personal recommendations, in order of preference, are below:

- **Obtain global consensus** - If a global consensus could be reached that little or no income should be allocated to tax havens, it would be a giant step forward. There would still need to be a determination as to how to allocate income between source and residence countries, but it would be very beneficial if tax havens could be substantially taken out of the equation.

How might this work? The scenario easiest to conceptualize would be a global agreement on some sort of formula apportionment method, but there are many others. For example, source countries could be required to impose withholding taxes on payments to a tax haven jurisdiction. In addition, a headquarters/residence country could be required to impose a tax on all income earned by foreign subsidiaries located in tax havens.<sup>26</sup>

Unfortunately, I am not optimistic about the chances of an effective global agreement occurring anytime soon, but if it does happen, it would be welcomed. Given global agreement may not

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<sup>24</sup> See *Tax Notes* 121 (Jan. 2, 2012) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1975975](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1975975)

<sup>25</sup> For example, see *International Competitiveness: Senate Finance Committee Staff Tax Reform Options for Discussion* (May 9, 2013) available at [www.finance.senate.gov/issue/?id=0587e4b4-9f98-4a70-85b0-0033c4f14883](http://www.finance.senate.gov/issue/?id=0587e4b4-9f98-4a70-85b0-0033c4f14883).

<sup>26</sup> A special rule would be needed to address MNCs headquartered or incorporated in tax havens.

occur or may not be effective, US policymakers should also consider the unilateral options discussed below.

- **Lower the corporate income tax to no more than 15%<sup>27</sup> and adopt some other revenue source (e.g., VAT, energy taxes, and/or financial transactions taxes)** – In a world where many foreign countries are competing through low corporate income tax rates, one has to wonder whether the US will ultimately have to capitulate and join the fray. A corporate income tax in the 15% range could balance the competitive issues facing both US MNCs and domestic corporations. Given the political issues faced by such a proposal, however, the chances of this policy suggestion being adopted any time soon are not very high. Therefore, I will say no more.
- **Keep the arms-length standard, but...**
  - **Overlay a minimum tax on tax haven earnings** – There are many different variations to this approach. In determining which to adopt, Congress should prefer those options that are easiest to administer. One general class of options is to identify a low-tax country (or foreign corporation) and apply a tax to some or all of the income from such country (or foreign corporation) without the benefit of a foreign tax credit.

If an approach of this type is ultimately adopted, I strongly recommend that all earnings of a tax haven should be included as opposed to trying to determine (i) excess earnings, or (ii) earnings attributable to intangible assets. This would rule out many proposals, including options “A” and “C” of the House Ways and Means October 2011 proposals.<sup>28</sup>

Again, from a simplicity perspective, it would be preferable if it is clear whether a foreign country is, or is not, a tax haven. Unfortunately, given the special deals that country’s like Ireland are willing to make with MNCs like Apple, relying on a published corporate tax rate may not work.<sup>29</sup> Thus, one may need to focus on a specific company’s fact pattern in the country.

- **Disallow US deductions for expenses attributable to foreign income** – Currently US tax law allows a MNC to take deductions (e.g., interest and G&A) in the US for expenses that may be attributable to foreign subsidiaries. This is especially a problem for those US

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<sup>27</sup> If the US corporate income tax rate is above 15% there is still will be a significant incentive for US MNCs to shift their income or operations to low-tax jurisdictions. As a result, even though discussions about lowering the US corporate income tax rate to the 25%-30% range are positive, I don’t believe they will materially alter the incentive to shift income and operations out of the US.

<sup>28</sup> See [http://waysandmeans.house.gov/uploadedfiles/discussion\\_draft.pdf](http://waysandmeans.house.gov/uploadedfiles/discussion_draft.pdf)

<sup>29</sup> One option could be to rely on the published tax law of a country, but make it clear that if any special deals are discovered the country will automatically be considered a tax haven (i.e., a death penalty).

MNCs that incur interest expense in the US and then equity fund foreign subsidiaries.<sup>30</sup> US tax law should not allow these deductions until the foreign income is recognized in the US.

- **Unilaterally replace the arms-length standard with a formula apportionment approach** – This approach has been advocated by some<sup>31</sup> and in my opinion is better than current law. However, there are potential issues that would need to be addressed, including (i) whether to base the formula on sales, or sales plus other factors of production (e.g., employees and/or tangible assets), and (ii) the need for anti-abuse rules in cases where sales are made to an intermediary in a tax haven country.

It should be emphasized the above discussion is equally applicable whether Congress decides to continue with the current hybrid system of worldwide taxation, or adopts a territorial system. However, if the US wants to adopt a territorial system, it should only be adopted if there is a high degree of confidence that the risk of income shifting is minimal. The least desirable option is to keep the current US tax system for taxing MNCs without any changes. The reason for this being that the current Subpart F rules effectively allow US MNCs to shift substantial amounts of income out of the US.

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This concludes my testimony and I would be pleased to answer any questions.

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<sup>30</sup> Or have much higher ratios of equity to assets.

<sup>31</sup> For example, Reuven Avi-Yonah and Michael Durst.

# Appendix

## Table of Contents

- 1 Techniques for Avoiding Subpart F Income
  - 1.1 Check-the-box regulations
  - 1.2 CFC look-through rule
  - 1.3 Contract manufacturing exemption
  - 1.4 Same-country exception
  
- 2 Proposal for Increased Transparency

## 1 Techniques for Avoiding Subpart F Income<sup>32</sup>

Once a US MNC has successfully shifted income into a tax haven, it must attempt to avoid the inclusion of such income in its US tax return (i.e., avoid Subpart F income). Subpart F is a very complicated area of the tax law, and the discussion below briefly discusses only two items.

- **Foreign Base Company Sales Income (FBCSI)<sup>33</sup>** – This provision is designed to tax income earned by a foreign subsidiary when the subsidiary does not materially participate in the generation of the income and the subsidiary either buys or sells personal property from or to a related party.

For example, if an Irish subsidiary of Apple (e.g., ASI) purchases personal property from a Chinese supplier (e.g. Foxconn) and sells the property to another Apple subsidiary outside of Ireland that in turns sells to a 3<sup>rd</sup> party customer, the FBSCI rules are generally intended to apply to both ASI and the related party. However, as described below, Apple is able to avoid the FBSCI rules through the use of the “check-the-box” regulations,<sup>34</sup> and possibly in the future through the so-called “contract manufacturing” exemption.<sup>35</sup>

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<sup>32</sup> IRC sections 951 to 965

<sup>33</sup> IRC 954(d)

<sup>34</sup> 301.7701-3. Apple reportedly claims they do not currently rely on the contract manufacturing exemption.

<sup>35</sup> 1.954-3(a)(4)(iv). Apple did not have any employees in ASI until 2012 and therefore was not eligible for the contract manufacturing exemption. One wonders whether in the future Apple will also argue that it avoids Subpart F by relying on the contract manufacturing exemption applies (i.e., have two arguments for avoiding Subpart F).

- **Foreign Personal Holding Company Income (FPHCI)**<sup>36</sup> – This provision is designed to tax interest, dividends, royalties, and certain other types of passive income earned by a foreign subsidiary. Thus, if a foreign subsidiary of Apple (e.g., AOI) directly or indirectly receives dividends or interest income from another Apple foreign subsidiary (e.g., AOE or ASI), the general FPHCI rules would treat such income as taxable in the US. However, as described below, Apple is able to avoid the FPHCI rules by use of (i) the check-the box regulations, (ii) the CFC look-through rule,<sup>37</sup> and/or (iii) the same country exception.<sup>38</sup>

In summary, Apple substantially avoids the application of these two subpart F provisions (i.e., FBCSI and FPHCI) through a combination of techniques referred to above (i.e., the check-the box regulations, the CFC look-through rule, the same-country exception). In addition, in the future Apple may be able to use the contract manufacturing exemption. See Sections 1.1 to 1.4 of this Appendix for more discussion of these techniques and specifically how Apple or other MNCs may use them.

## 1.1 Check-the-box regulations<sup>39</sup>

These regulations adopted by the IRS/Treasury in 1996 allow US MNCs to create so-called “hybrid entities” where the entities may be taxed as an entity in one tax jurisdiction and either a pass-through entity or a disregarded entity in the other tax jurisdiction. Although there are multiple tax planning uses for hybrid entities, one of the most common is to treat an entity for US tax purposes as disregarded and therefore also disregard transactions between the entity and its parent.

Apple appears to benefit from the check-the-box regulations by treating many entities as disregarded for US tax purposes and thus transactions between such entities are disregarded. As a result, the income that could otherwise be taxable as Foreign Base Company Sales Income (FBCSI) or Foreign Personal Holding Company Income (FPHCI) in the US disappears.

Below is a simplified illustration of Apple’s legal structure for its European sales:<sup>40</sup>

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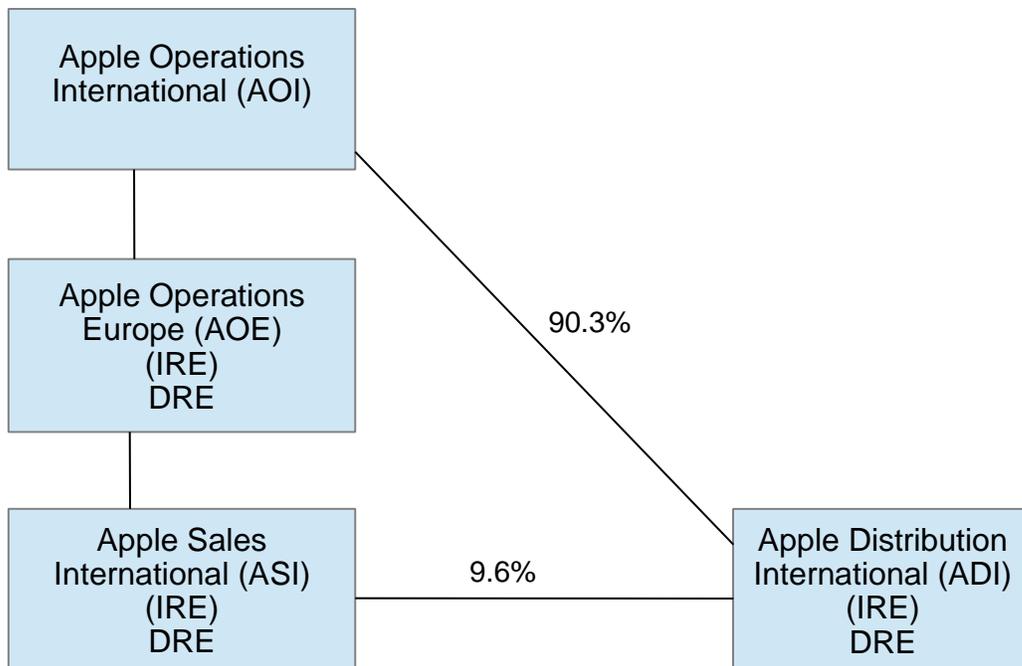
<sup>36</sup> IRC 954 (c).

<sup>37</sup> IRC 954(c)(6).

<sup>38</sup> IRC 954(c)(3).

<sup>39</sup> 301.7701-3.

<sup>40</sup> The information obtained is from a review of the information Apple supplied PSI.



**Notes:**

- 1) AOI is incorporated in Ireland, but “managed and controlled” outside of Ireland. Therefore this entity is not currently taxed in any country.
- 2) Baldwin Holdings Unlimited, a British Virgin Islands entity, owns less than 0.1% of AOI, AOE, ASI, and ADI
- 3) IRE = Incorporated in Ireland. Note that AOI is not subject to tax in Ireland and ASI is only taxed on very limited activities.
- 4) DRE = disregarded entity for US tax purposes

From an operating perspective, ASI owns the right to Apple’s development rights outside of the Americas. Thus, ASI contracts with Foxconn to manufacturer Apple products and immediately sells them to ADI who in turns sells the products further down the distribution chain.<sup>41</sup> Substantial pre-tax profits (e.g., \$22 billion in fiscal 2011 and \$74 billion for the 4 years 2009 to 2012) are accumulated in ASI and relatively minor amounts of pre-tax profit are reported in ADI and other downstream affiliates.

From a legal perspective, AOI, AOE, ASI, and ADI are all incorporated in Ireland and treated as corporations under Irish law.<sup>42</sup> However, from a US tax perspective, Apple has made check-the-box elections on AOE, ASI, ADI, and other Apple affiliates further down the distribution chain. The end result

<sup>41</sup> In some cases, it appears the products may be sold to 3<sup>rd</sup> parties while in other cases they are sold to Apple affiliates who eventually sell to 3<sup>rd</sup> parties.

<sup>42</sup> AOE, ASI, and ADI are all taxed in Ireland, but AOI is not because it is managed and controlled elsewhere. In addition, ASI after 2009 ASI reportedly does not meet Irish residency requirements and therefore is only taxed on certain limited business activity in Ireland.

is that Apple appears to treat AOI, AOE, ASI, ADI, and the downstream affiliates as one big entity for US tax purposes and therefore the inter-entity transactions are ignored.<sup>43</sup>

For example, if sales from ASI to ADI were respected (i.e., not ignored), Apple could have FBCSI.<sup>44</sup> However, because Apple has checked-the-box on ADI to treat ADI as a disregarded entity, sales between ASI and ADI are totally ignored for US tax purposes and FBCSI is avoided.

In addition, ASI makes substantial annual dividends (e.g., over \$6 billion in fiscal 2011) to AOE that in turn makes dividends to its parent, AOI. Although dividends are a class of income that can cause FPHCI, Apple avoids the issue by checking-the-box on both AOE and ASI to treat them as disregarded entities. As a result the dividends from ASI to AOE and AOE to AOI are disregarded and Apple avoids FPHCI.<sup>45</sup>

## 1.2 CFC look-through rule<sup>46</sup>

The CFC look-through rule was enacted in 2006 by Congress to allow US MNCs to re-characterize what would otherwise be subpart F income (e.g., dividends, interest, and royalties) by looking-through to the character of the income earned by the entity paying the dividend, interest, royalty, etc...

For example, when AOI receives dividends from both Irish entities (e.g., AOE) and non-Irish entities, such dividends could be FPHCI subject to US tax. However, to the extent the dividends are attributable to active income from the subsidiary, the CFC look-through rule effectively re-characterizes the dividend income as active income and FPHCI can be avoided.

Apple appears to have benefited from the application of the CFC look-through rule to re-characterize dividend income as active income and therefore avoid Subpart F income. It does not appear that any substantial amount of interest or royalty income was re-characterized as operating income. Nevertheless, it is important to illustrate how the CFC look-through rule can be used to avoid US taxable income in certain cases that many may view as abusive.

- **Baseline Case** - As a baseline, assume a US Parent borrows from a 3<sup>rd</sup> party in the US and on-lends the borrowed funds to foreign operating subsidiaries located in a relatively high tax country. For US tax purposes the US Parent will have interest expense from the 3<sup>rd</sup> party and

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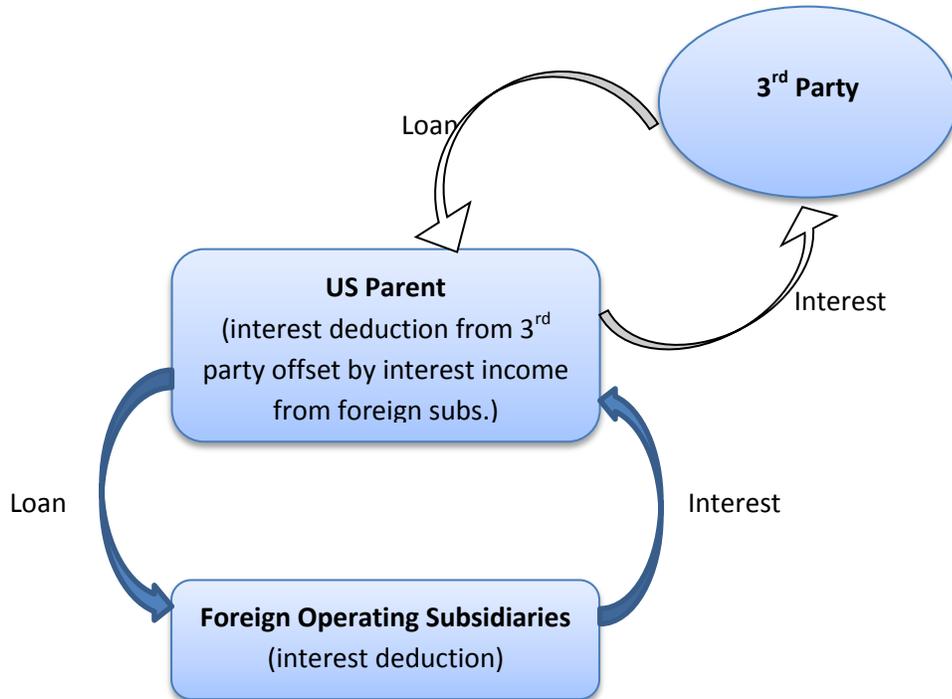
<sup>43</sup> It is not clear how Apple treats Baldwin Holdings' <0.1% ownership in the disregarded entities. If Baldwin Holdings' ownership is respected, technically one would expect ASI, AOE, and ADI to be partnerships for US tax purposes which could add complications to the US tax analysis.

<sup>44</sup> As discussed in Section 1.3 of this Appendix, FBCSI can also be avoided if ASI is a substantial participant in the manufacturing process. Thus, the contract manufacturing rules may allow Apple to avoid FBCSI but it is not clear whether they are also making this argument.

<sup>45</sup> Apple may also be able to avoid FPHCI by virtue of either the CFC look-through-rules, or the same country exception.

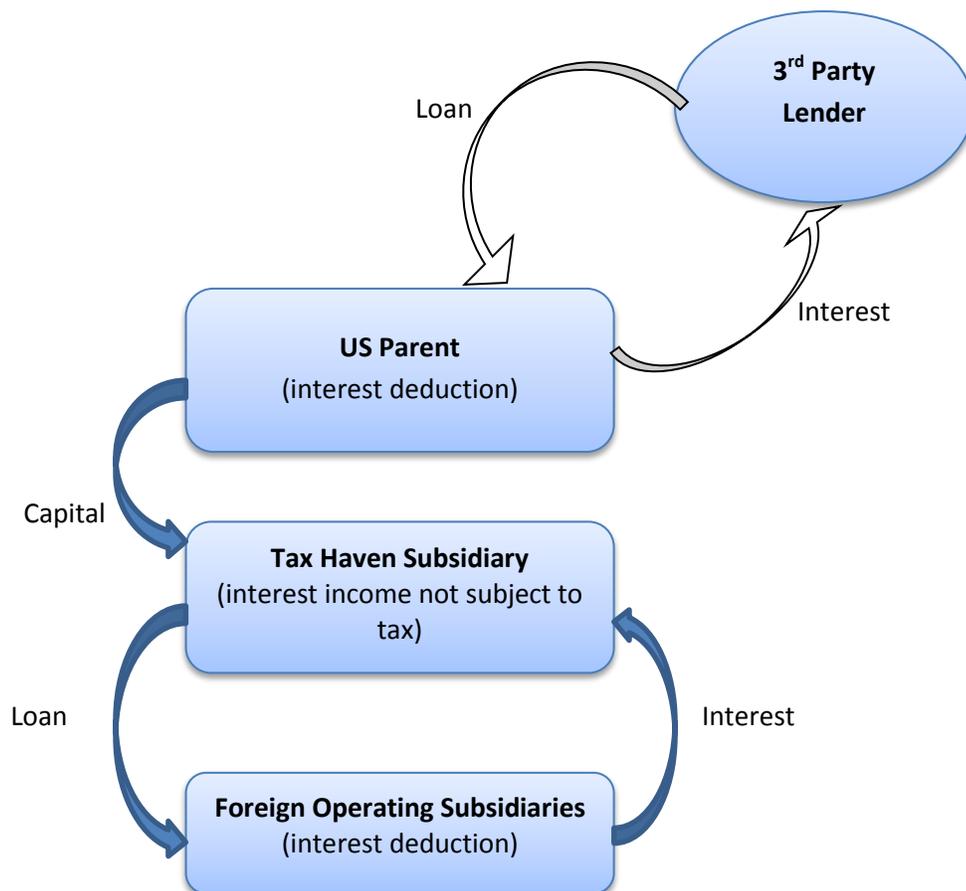
<sup>46</sup> IRC 954(c)(6).

interest income from the foreign operating subsidiaries. Presumably the two amounts will roughly offset one another and thus there is no US tax consequence from the US Parent acting as an intermediary for the loan. For foreign tax purposes, the foreign operating subsidiaries should receive a tax deduction for the interest paid to the US parent. The diagram below illustrates this simple funding scenario.



In summary, the tax results from this simple baseline case seem to be very reasonable (i.e., the interest deduction is ultimately claimed in the foreign operating subsidiaries and there is no material deduction or income in the US parent).

- **Alternative Scenario** – Assume the US Parent again borrows from a 3<sup>rd</sup> party, but instead of the US Parent directly on-lending to its foreign operating subsidiaries, the US Parent contributes the borrowed funds to the capital of a foreign subsidiary located in a country with no income tax (Tax Haven Subsidiary). Then assume the Tax Haven Subsidiary loans the funds to foreign operating subsidiaries around the world in high-tax countries. The diagram below illustrates this more complicated funding structure.



From a legal entity perspective, the consequences of this structure are (i) the US Parent will have interest expense, (ii) the Tax Haven Subsidiary will have interest income, and (iii) the Foreign Operating Subsidiaries will have interest expense. From a US tax perspective, the question is whether the interest income earned by the Tax Haven subsidiary is FPHCI and therefore included in the US Parent's US taxable income?

The answer is the Subpart F rules were originally designed to significantly discourage this sort of funding structure. However, after application of the CFC look-through rule, the interest income earned by the Tax Haven Subsidiary will likely be re-characterized as operating income because the interest is being paid from an operating entity. The end result is that the US MNC will obtain two interest deductions (i.e., one at the US Parent and one at the Foreign Operating Subsidiaries) and not pay tax on the interest income in any location. When compared with the Baseline Case, this Alternative Scenario results in income being excluded from the US tax return.

Before discussing other techniques for avoiding Subpart F income, two additional items should be noted about the above financing structure:

- **Check-the-box regulations can accomplish the same result** - If the CFC look-through rule did not exist, the US MNC in the example above could accomplish the same result by checking-the-box on foreign operating subsidiaries to treat them as disregarded entities. Since the foreign operating subsidiaries would be viewed as part of the Tax Haven Subsidiary, the interest income would be disregarded for US tax purposes (i.e., it disappears).
- **Structure is also applicable to intangible assets** - The example above assumes the Tax Haven Subsidiary was used as a finance vehicle. However, the above simple structure can also be used to avoid FPHCI on royalties from intangible assets. For example, a Tax Haven Subsidiary could use funds contributed by its US Parent to acquire rights to intangible assets that are then licensed (or sublicensed) to foreign operating subsidiaries around the world. In summary, FPHCI on the royalty income can be avoided through either (i) the application of the CFC look-through rule, or (ii) the check-the-box regulations.

### 1.3 Contract manufacturing exemption<sup>47</sup>

The original Subpart F rules were designed to exclude from US taxation the income earned by a foreign corporation to the extent (i) the property was manufactured in the foreign country or (ii) the property was sold to customers in such country. In the good old days, “manufactured” meant that the foreign corporation had a plant in the foreign country and actually manufactured something in the plant. Not so any more.

With the advent of contract manufacturing, manufacturing is now often done by a third party in a low-cost country (e.g., China, Philippines, and Bangladesh). Thus, the tax issue became whether a foreign subsidiary of a US MNC could qualify for the manufacturing exemption to Subpart F by supervising or making a “substantial contribution” to the contract manufacturing operations of the 3<sup>rd</sup> party.

In 2008 the IRS and Treasury issued regulations allowing supervision of contract manufacturing to qualify as a “substantial contribution” to the manufacturing process. As a result, foreign corporations may qualify for the contract manufacturing exemption to Subpart F and effectively avoid substantial amounts of US taxable income.<sup>48</sup>

Although there could be many potential changes to the contract manufacturing exemption, the easiest would be to just eliminate it. Another option might be to only allow the foreign corporation to avoid Subpart F to the extent of the labor cost of such supervisory services plus some reasonable profit margin.

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<sup>47</sup> Regulation 1.954-3(a)(4)(iv)

<sup>48</sup> Note that reportedly Apple does not currently rely on the contract manufacturing exemption. As Apple adds employees to ASI, it is possible that Apple could qualify in the future.

## 1.4 Same-country exception<sup>49</sup>

Although the check-the-box regulations, the CFC look-through rule, and the contract manufacturing exemption are the primary tools US MNCs use to avoid Subpart F income, one other tool worth mentioning surrounds the same-country exception. This is especially true in Apple's case because their fact pattern would allow them to benefit from the same-country exception if for some reason the three primary tools for avoiding Subpart F were not available.

As previously described in this testimony, AOI is an entity incorporated in Ireland but considered managed and controlled elsewhere to avoid Irish tax on dividends from non-Irish companies. In 2011 there were over \$6 billion of dividends from AOE to AOI not taxed in Ireland. From a US tax perspective, the question is whether the \$6 billion of dividends from AOE to AOI should be considered FPHCI and therefore immediately taxed in the US?

Thanks to the application of the check-the-box regulations and/or the CFC look-through rules; this \$6 billion is not FPHCI. However, it should be noted that even if the check-the-box regulations and the CFC look-through rule were unavailable, it appears Apple would not have FPHCI by virtue of the same-country exception. The same-country exception provides that dividends and interest received by AOI from AOE will not be FPHCI because AOE is created or organized in the same country as AOI (i.e., Ireland). This is the case even though AOI is not taxed in Ireland because it is "managed and controlled" outside of Ireland.

Thus, one needs to question whether it is appropriate to allow the same-country exception in this type of case. Congress may want to consider modifying the same country exception to provide that it is only applicable if the two entities are subject to taxation in the same country.

## 2 Proposal for Increased Transparency

Information is money - - Although this phrase is used commonly in the business world to refer to the ability of businesses to generate revenue from the possession of valuable information, it is also applicable to the relationship between the tax departments of many MNCs and tax officials around the world. Historically many MNCs have made it very difficult for tax officials to obtain information with the end result that either the tax officials (i) don't obtain the necessary information to propose potential audit adjustments, or (ii) spend so much time attempting to obtain information on one issue that they don't have as much time to investigate other issues.

Because of this concern, the IRS adopted Schedule UTP in 2010.<sup>50</sup> Schedule UTP now requires corporations to disclose tax issues to the IRS when the corporation has recorded a tax reserve for an

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<sup>49</sup> IRC 954(c)(3)

issue on its audited financial statement. However, the disclosure on Schedule UTP is limited to a few sentences and is only intended to identify issues for the IRS on a very general level.

When Schedule UTP was being developed there was significant concern expressed by some at the IRS that additional information surrounding transfer pricing issues was needed. A decision was made that Schedule UTP was not the correct vehicle to request such information,<sup>51</sup> but this decision did not foreclose the possibility of future additional disclosure specifically targeting transfer pricing. Since I departed the IRS almost 3 years ago, I do not know whether the IRS is currently considering any additional transfer pricing disclosure. If not, they should, especially for publicly traded MNCs. Additional transfer pricing related information could help the IRS more quickly identify the location and scope of any income shifting.

Information could be obtained on an aggregate basis (e.g., US vs. non-US), country-by-country basis, and/or on an entity by entity basis (i.e., at the controlled foreign corporation (CFC) level). At a minimum, aggregate information could include the following:

	Pre-tax income	Tax Expense		Liability per the tax return	# of Employees	Sales	Other Information
		Current	Deferred				
US				n/a			
Non-US							
Consolidated financial statements							

Note that some of this information is now included in audited financial statements, but some is not. In addition to making this available to the IRS and other tax authorities, one could also consider making it available to the public. Although MNCs would surely complain, the information disclosed is relatively aggregated and in many cases is already publicly disclosed.

Additional information could also be collected on a CFC by CFC basis<sup>52</sup>, including that requested in the following two tables:

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<sup>50</sup> For information on Schedule UTP, see J. Richard (Dick) Harvey, Jr., *Schedule UTP: An Insider's Summary of the Background, Key Concepts, and Major Issues*, DePaul Business and Commerce Law Journal (Spring 2011) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1782951](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1782951).

<sup>51</sup> As the lead architect of Schedule UTP, I personally concurred with this decision.

<sup>52</sup> Because of its potential impact on a MNC's competitive position, I would not recommend publicly disclosing CFC specific information at this time. However, I would not completely rule it out at some time in the future (e.g., if MNCs continue to shift income to low-tax jurisdictions and other efforts have failed to prevent it).

CFC name	How is the entity classified (i.e., taxable, disregarded, or flow-through)?		Financial Statement Information				
	Foreign Tax Purposes	US Tax Purposes	Pre-Tax Income	Federal tax expense		Foreign tax expense	
				Current	Deferred	Current	Deferred
A							
B							
etc...							

CFC name	US Federal tax		Foreign tax		Other Information (e.g., # of employees and/or employee compensation)
	E+P	Subpart f	Taxable income	Tax Liability	
A					
B					
etc...					

Although some of this information is currently collected on IRS Form 5471, *Information Return of US Persons With Respect to Certain Foreign Corporations*, some is not. In addition, I suspect there is additional information that IRS field agents would find useful. My bottom line suggestion is the IRS should determine what information would be useful and design a form to collect it. Whether this is a new form, or some variation of an existing form does not matter. The key is to allow IRS agents to quickly identify where income is being shifted to low-tax jurisdictions, and how such shifting is being accomplished.